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Israel: Balance of Payments and the Role of US Aid

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An Intelligence Assessment

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Israel: Balance of Payments and the Role of US Aid [redacted]

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An Intelligence Assessment

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This assessment was prepared by [redacted] Office of Near East–South Asia Analysis. Comments and queries are welcome and may be directed to the Chief, Arab-Israeli Division, [redacted]

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This paper was coordinated with the Directorate of Operations and the National Intelligence Council. [redacted]

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Israel: Balance of Payments and the Role of US Aid [redacted]

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Key Judgments

Information available as of 1 October 1982 was used in this report.

Israel faces a large and growing financial gap over the next several years, the more so if Finance Minister Aridor attacks triple-digit inflation at the expense of the country's balance-of-payments position. The civilian goods and services deficit will widen dramatically under present government policies. The problem will be exacerbated by slow growth in exports since manufacturers are finding a growing domestic market for their goods. Even under Israel's present procurement plans, the military deficit will also grow as defense imports outstrip US military aid; this deficit could grow substantially if the Israelis move to replace equipment lost or damaged during the invasion of Lebanon.

US financial assistance has been and will continue to be vital to Israel. Even if US aid continues at present levels, the Israeli Government will be forced by dwindling foreign exchange reserves to take austerity measures by 1986. If US aid were cut off, austerity would probably have to be introduced as early as next year, at the cost of economic growth. If the United States took less drastic action, for example, eliminating economic aid and grants on military assistance, Israeli officials could probably put off such measures until 1984.

[redacted]

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Israel: Balance of Payments and the Role of US Aid [redacted]

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We have used the CIA econometric model of Israel to project the financial gap—the sum of the civilian goods and services deficit, self-financed military payments, and debt repayment—likely to face the Israeli Government under various scenarios.[1] A baseline scenario was generated assuming that the Israeli Government continues current economic policies and US aid remains at current levels. We then looked at several alternative scenarios, comparing them to the baseline. [redacted]

Table 1
Israel: Balance of Payments

Million US $

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	1978	1979	1980	1981 [a]
Civilian goods and services balance	−1,671	−2,718	−2,214	−2,219
Exports	6,841	8,289	10,119	10,841
Goods	4,075	4,717	5,800	5,929
Services	2,766	3,572	4,319	4,912
Imports	8,512	11,007	12,333	13,060
Goods	5,282	6,916	7,454	7,459
Services	3,230	4,091	4,879	5,601
Self-financed military imports	293	250	250	497
Military import payments	1,690	1,420	2,018	2,404
US military assistance	1,397	1,170	1,768	1,907
Debt repayment	900	893	1,025	1,730
Financial gap	**2,864**	**3,861**	**3,489**	**4,446**
Sources of financing	3,968	4,299	3,777	4,591
Unilateral transfers	1,229	1,400	1,471	1,521
US economic assistance	875	980	785	785
Israeli bonds	430	414	450	477
Other capital including short-term borrowing	1,327	1,501	1,064	1,799
Net foreign investment	107	4	7	9
Change in reserves	1,104	438	288	145

[a] Estimated.

[redacted]

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Baseline Scenario

With the help of the econometric model, we project that the financial gap could easily increase from $4 billion this year to $7.5 billion in 1985, barring changes in Israeli economic policies or external shocks. We have assumed that the government will increase real domestic military spending over the next few years as a result of the invasion of Lebanon, while domestic nonmilitary expenditures will be cut in 1982-83 to help keep the budget deficit from increasing, and then rise slowly in 1984-85. Economic growth in the OECD countries, which is a factor in determining Israeli exports, is assumed to be a moderate 2 to 3 percent per year. [redacted]

Traditional sources of financing—private transfers, bond sales, and US economic aid—are unlikely to keep pace. Thus, we believe Israeli officials will be forced to rely even more heavily on foreign bankers—primarily in the United States—for short- and medium-term loans if they want to avoid drawing down foreign exchange reserves. [redacted]

Israel has had little difficulty managing this year's financial gap. The trade deficit has widened by $150 million so far this year, according to available data.[2] Export receipts through the first eight months are 6 percent below the same period last year due principally to growing domestic demand, although recession in Europe and the United States and temporary disruptions caused by the invasion of Lebanon are also factors. Tourism Ministry officials estimate that tourist receipts will be reduced by at least $100 million—because of the fighting, the number of visitors to Israel this summer has dropped sharply, compared with the same period last year [redacted]

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[1] A discussion of the Israeli econometric model and the effect of several possible economic policies appears in the appendix [redacted]

[2] Due to a strike at the Central Data Processing Office earlier this year, import data for February and March are unavailable. [redacted]

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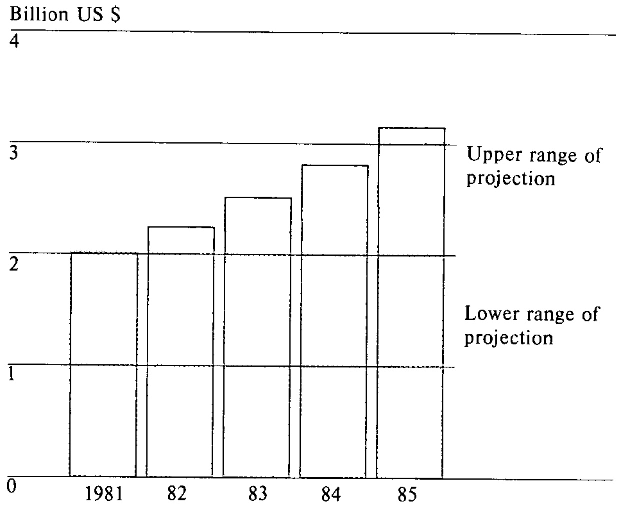
Table 2
Israel: Baseline Financial Gap [a]

Million US $

	1982	1983	1984	1985
Civilian goods and services balance	−2,471	−3,458	−4,519	−5,471
Exports	11,739	12,981	14,248	15,651
Imports	14,210	16,439	18,767	21,122
Self-financed military imports	−66	224	696	606
Military import payments	2,055	1,958	2,133	2,014
US military assistance	2,121	1,734	1,437	1,408
Debt repayment	1,545	1,470	1,380	1,455
Financial gap	**3,950**	**5,152**	**6,595**	**7,532**

[a] Projected using Israeli econometric model.

Figure 1
Israel: Projected Traditional Capital Inflows [a]



[a] Unilateral transfers and Israeli bond sales.

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Foreign exchange reserves—$3.5 billion at the end of June—have held steady so far this year, implying that the Israeli Government has been able to find the funds to cover the financial gap. No capital flow data for this year are available; thus, we do not know the extent to which the Israelis have had to resort to commercial bank borrowing. Aridor said he hopes to raise an additional $200 million in bond sales—roughly equivalent to the increase after the 1973 war—in the wake of the Israeli invasion of Lebanon.

The projected average annual real GNP growth rate of 4 percent through 1985 will boost civilian imports by nearly 5 percent a year in real terms. At the same time, exports will be held to only a 2.4-percent annual growth. Because Israeli producers can switch rapidly between the domestic and foreign markets and plants are running at about capacity, export growth tends to be sluggish when domestic demand is buoyant. As a result, the civilian goods and services deficit could reach $5.5 billion by 1985.

According to the weapons procurement schedule outlined in the aid request the Israelis presented last year, foreign exchange expenditures for weapons will outstrip US military aid by $1.5 billion in 1983-85. We are assuming that scheduled drawdowns of Sinai redeployment aid and Foreign Military Sales (FMS) credits will be continued at $1.4 billion a year—the level Congress approved for FY 1982. The administration has proposed FMS credits of $1.7 billion for FY 1983. The Israelis may revise their procurement plans, particularly if they want to replace equipment lost or damaged during the invasion of Lebanon. 25X1

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We believe Israeli officials will find it difficult to avoid drawing down reserves before 1986. Unilateral transfers and Israeli bond sales, which covered almost half of last year's financial gap, are unlikely to increase much faster than the 6-percent annual 25X1

The US Connection

Since 1962 the United States has provided $20 billion in financial assistance to Israel; military aid totaled $14.3 billion, while economic support amounted to $5.7 billion. US military and economic assistance was $2.7 billion last year—$1.6 billion was grant aid. Israel last year garnered nearly half as much foreign exchange from US aid as from its commodity exports. Israel will receive $2.9 billion this year—$1.3 billion as grants—the single largest recipient of US aid. Because almost half of the aid Israel has received from the United States since 1962 has been in the form of grants rather than loans, debt servicing costs are much lower than they otherwise would have been, thus narrowing the financial gap.

The administration has proposed that Foreign Military Sales (FMS) credits be increased by $300 million to $1.7 billion in FY 1983. In addition, a Senate subcommittee has passed legislation increasing economic aid by $125 million to $910 million—equivalent to the principal and interest payments owed on debt to the US Government. A recommendation was made that future economic aid be at least equivalent to the debt service owed to the United States.

growth rate recorded since 1978. Contributions from Jews living abroad do not respond to economic crises; donations soared in 1974 after the October 1973 war but fell back to traditional levels in 1975 and 1976 when Israel was in a severe foreign exchange crunch. Aridor's goal of increasing bond sales by $200 million may not be met if Jews abroad who do not support Begin's policies in Lebanon choose to withhold contributions. US economic aid is scheduled to remain at $785 million.

The Israeli Government will be looking to commercial bank borrowing over the next few years to provide funds to cover a growing portion of the financial gap at a time when bankers are becoming increasingly concerned about international lending. We believe that bankers think the US Government and foreign Jews, Israel's two largest creditors, would not press for payment in a squeeze; thus, the bankers are willing to carry more Israeli debt than they would normally consider prudent. Nevertheless, bankers may be unwilling to increase their lending to Israel by the amounts that would be needed to avoid foreign exchange reserve drawdowns in 1984 and 1985.

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Anti-Inflation Program

According to the US Embassy, Aridor plans to announce a new program to bring the inflation rate down to 85 percent within a year—consumer prices for the first eight months of the year rose at an annual rate of 135 percent. The major element of the program is a limit on the depreciation rate of the shekel to between 4 and 5 percent per month to restrain the rise in prices of imported goods. Since taking office, Aridor has advocated using exchange rate policy to fight inflation. He now has a governor of the Bank of Israel—Moshe Mandelbaum—who we believe will go along with this scheme because he has supported Aridor's policies across the board; Mandelbaum's predecessor opposed such a policy because of the damage it would do to exports and refused to implement it. 25X1

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The gains on the inflation front will come at the expense of Israel's balance of payments. Using our econometric model, we project that by 1985 the financial gap would be $2 billion larger than under the baseline scenario. We used the same assumptions as in the baseline except that we limited the depreciation rate of the shekel to 4.5 percent per month from October 1982 to December 1983—the time period in which Aridor wants to meet his inflation goal. In addition, the annual average real GNP growth rate would be a percentage point lower.

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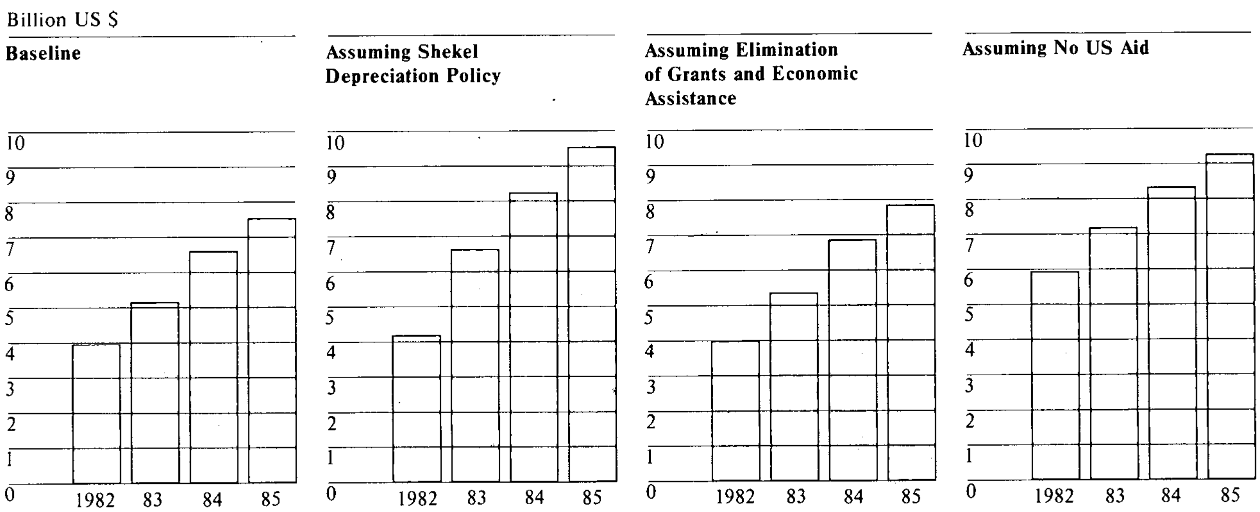
Figure 2
Israel: Financial Gap Under Various Scenarios[a]



[a] Projections using econometric model of Israel.

[redacted]

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Slowing the depreciation rate will reduce the competitiveness of Israel's exports, resulting in export volume declines of 1 percent annually compared with growth of 2.4 percent in the baseline scenario. According to US Embassy reporting, officials of the Manufacturers' Association have criticized the plan because of its detrimental effect on exports; the Association, however, does not have much political clout and probably would not be able to dissuade Aridor. Although lower prices will increase demand for imported goods, this will be offset by the impact of lower growth, and the real annual growth of civilian imports will be a percentage point lower than in the baseline case. The greater impact on exports, however, will increase the civilian goods and services deficit. [redacted]

If the depreciation rate is reduced, we believe Israel would probably have to start drawing down reserves as early as next year, when most of the impact of the shekel depreciation policy would be felt. The financial gap would be $1.5 billion larger in 1983 than in the baseline scenario. Commercial bankers may be reluctant to extend additional financing if they perceive that the Israeli Government is deliberately pursuing policies that are exacerbating its balance-of-payments situation. In addition, Aridor may need to use some of the $3.5 billion in reserves to defend the exchange rate. [redacted]

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Israel: Impact of US Aid

Using our econometric model, we have estimated the tremendous impact of US military and economic aid on the Israeli economy. Assuming the absence of all US aid this year and no Israeli policy adjustments, the financial gap would have been $2 billion, or almost 50 percent, larger than in the baseline case. Foreign exchange reserves could have been depleted to cover the larger gap, but policy adjustments would have quickly become necessary. If the Israeli Government had tried to protect its foreign exchange position—we assumed government spending was reduced to offset the decline in revenues—real GNP would have declined by nearly 4 percent instead of growing by the 3.6 percent projected in the baseline case.

The impact would have been less if, for example, the United States had continued to provide military aid—but totally in the form of loans—and no economic aid. Economic growth this year would have been 0.2 percentage point lower than in the baseline scenario, and the financial gap would have been $40 million larger. Since economic aid is used to cover the gap, the Israeli Government would have had to use some of its foreign exchange reserves to cover the financial gap unless commercial borrowing was arranged.

The impact would be much greater than implied above, however, because US assistance has a cumulative impact on the Israeli economy over time. If, for example, US aid were totally cut off through 1985, the financial gap in that year could reach $9.3 billion, compared with $7.5 billion in the baseline case. Although real GNP in this scenario would grow faster than in the baseline, this would result from lower inflation due to higher imports. The Israelis, however, could not afford the resulting deterioration of their balance of payments.

Foreign exchange reserves would quickly be depleted, forcing Israeli officials to take action. If government spending were reduced to offset the decline in revenues, the financial gap in 1985 would be $3.3 billion lower than in the baseline scenario, but real GNP would decline at an average annual rate of 5 percent compared with average annual growth of 4 percent in the baseline.

Moreover, commercial credit has probably been more generous as a result of the financial resources provided to the Israeli Government by the United States. We believe bankers would probably interpret any kind of aid reduction as a sign of US displeasure with Israel and, depending on the severity of the US action, limit their own lending or charge higher interest rates. The impact on contributions by foreign Jews is more difficult to foresee; it is conceivable that contributions could decline if, in particular, Jews in the United States believed US peace proposals had merit and the Israeli Government was being intransigent.

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Likely Adjustments to Government Policy

The financial gap implied by these scenarios will force the Israelis to press for additional US aid or to implement austerity. We believe the Israeli Government would only resort to a major austerity program to deal with its balance-of-payments problems if there were no other options. Israeli officials are reluctant to incur the political costs involved in a meaningful austerity plan. These officials have also publicly stated that they have a moral obligation to provide a healthy economic climate for foreign Jews taking up permanent residence in Israel. 25X1

Instead, Israeli policymakers would prefer to make up the difference between the financial gap and traditional sources of funds through increased US aid or, alternatively, commercial borrowing. The Israelis have enough foreign exchange reserves—$3.5 billion is sufficient to cover more than five months of civilian commodity imports—to cushion the impact of Aridor's exchange rate policy or potential US aid cutbacks for a time. 25X1

At some point—by 1985 in our baseline scenario and even sooner under Aridor's exchange rate policy or in the event of reductions in US aid—dwindling foreign exchange reserves will force the Israeli Government to implement austerity measures. If this became necessary because of lower amounts of US aid, particularly if aid was completely cut off, we believe the Israeli Government would attempt—probably successfully—to generate public support for austerity by claiming the measures were necessary in order to demonstrate its independence from the United States. 25X1

Appendix

The Israeli Econometric Model and Various Scenarios

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The CIA econometric model of Israel is designed to make forecasts of Israeli economic performance. Using exogenous variables ranging from Israeli fiscal policies to OECD growth rates, the model projects various endogenous variables. These variables include:

- Measures of Israel's real domestic economic performance, including GNP, private consumption, and private investment.
- Israeli inflation as measured by the GNP deflator.
- Measures of Israel's balance-of-payments position, including imports and exports and the exchange rate.

Using the model, we have developed several scenarios to measure the impact of Israeli policy changes or external shocks. We started with a baseline scenario that assumes that the Israeli Government continues to pursue current economic policies and that US aid remains at present levels. We then looked at what would happen if Finance Minister Aridor follows through on his plan to reduce inflation by slowing the depreciation rate of the shekel. The average exchange rate for 1982 and 1983 was set at the level that would result if the shekel depreciates by 4.5 percent per month from October 1982 to December 1983

We then tried to measure the impact of US aid on the Israeli economy by eliminating all US military and economic aid. In addition, we ran a scenario in which Israeli officials reacted to the cutoff of revenues by cutting government expenditures by the same amount. To analyze the impact of US measures less drastic than an aid cutoff, we ran a scenario in which only economic aid is cut off and military aid is totally in the form of loans.

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Table 3
Israel: Baseline Scenario

	1982	1983	1984	1985
	Percent change			
Real GNP	3.6	5.1	4.8	2.7
Real private consumption	2.9	7.1	6.2	5.2
Real government consumption	−5.6	−9.7	22.7	−6.9
Domestic nonmilitary	−5.0	−2.0	1.0	1.0
Domestic military	3.0	3.0	2.0	1.0
Foreign military	−16.5	−37.1	110.1	−22.8
Real civilian exports	1.0	3.5	2.7	2.3
Real civilian imports	1.8	8.1	6.0	3.8
GNP deflator	152.3	169.7	197.1	226.4
	Million US $			
Civilian goods and services deficit	2,471	3,458	4,519	5,471
Self-financed military payments	−66 [a]	224	696	606
Financial gap	3,950	5,152	6,595	7,532

[a] Minus sign indicates a surplus.

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Table 4
Israel: Shekel Depreciation Policy

	1982	1983	1984	1985
	Percent change			
Real GNP	2.8	0.7	5.3	3.6
Real private consumption	2.9	8.1	6.2	5.3
Real government consumption	−5.6	−9.7	22.7	−6.9
Domestic nonmilitary	−5.0	−2.0	1.0	1.0
Domestic military	3.0	3.0	2.0	1.0
Foreign military	−16.5	−37.1	110.1	−22.8
Real civilian exports	−1.1	−8.1	3.1	2.8
Real civilian imports	1.2	3.1	6.3	5.1
GNP deflator	149.7	156.5	177.2	194.1
	Million US $			
Civilian goods and services deficit	2,700	4,927	6,154	7,467
Self-financed military payments	−66	224	696	606
Financial gap	4,179	6,621	8,230	9,528

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Table 5
Israel: Eliminate Grants and Economic Assistance

	1982	1983	1984	1985
	Percent change			
Real GNP	3.4	5.4	4.7	2.7
Real private consumption	2.9	8.3	6.3	5.4
Real government consumption	−5.6	−9.7	22.7	−6.9
Domestic nonmilitary	−5.0	−2.0	1.0	1.0
Domestic military	3.0	3.0	2.0	1.0
Foreign military	−16.5	−37.1	110.1	−22.8
Real civilian exports	1.0	3.6	2.7	2.3
Real civilian imports	1.8	9.0	6.0	3.8
GNP deflator	150.0	162.5	185.1	208.8
	Million US $			
Civilian goods and services deficit	2,515	3,651	4,772	5,785
Self-financed military payments	−66	224	696	606
Financial gap	3,994	5,345	6,848	7,846

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Table 6
Israel: No US Aid

	1982	1983	1984	1985
	Percent change			
Real GNP	4.2	7.3	5.0	2.9
Real private consumption	2.9	11.8	6.7	6.0
Real government consumption	−5.6	−9.7	22.7	−6.9
Domestic nonmilitary	−5.0	−2.0	1.0	1.0
Domestic military	3.0	3.0	2.0	1.0
Foreign military	−16.5	−37.1	110.1	−22.8
Real civilian exports	1.1	3.9	2.8	2.3
Real civilian imports	1.9	12.4	6.0	3.9
GNP deflator	147.1	152.3	173.5	194.3
	Million US $			
Civilian goods and services deficit	2,328	3,752	4,820	5,786
Self-financed military payments	2,055	1,958	2,133	2,014
Financial gap	5,928	7,180	8,333	9,255

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Table 7
Israel: Policy Adjustment to No US Aid

	1982	1983	1984	1985
	Percent change			
Real GNP	−3.8	−8.3	−5.5	−2.5
Real private consumption	2.9	−0.7	−3.6	−4.1
Real government consumption	−29.6	−42.2	6.3	−34.9
Domestic nonmilitary	−40.0	−50.0	−70.0	−90.0
Domestic military	−32.0	−42.0	−62.0	−82.0
Foreign military	−16.5	−37.1	110.1	−22.8
Real civilian exports	−0.5	0.9	0.2	0.7
Real civilian imports	0.7	−6.7	−3.4	−1.3
GNP deflator	132.1	129.7	110.4	88.7
	Million US $			
Civilian goods and services deficit	2,178	1,255	906	780
Self-financed military payments	2,055	1,958	2,133	2,014
Financial gap	5,778	4,683	4,419	4,249

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